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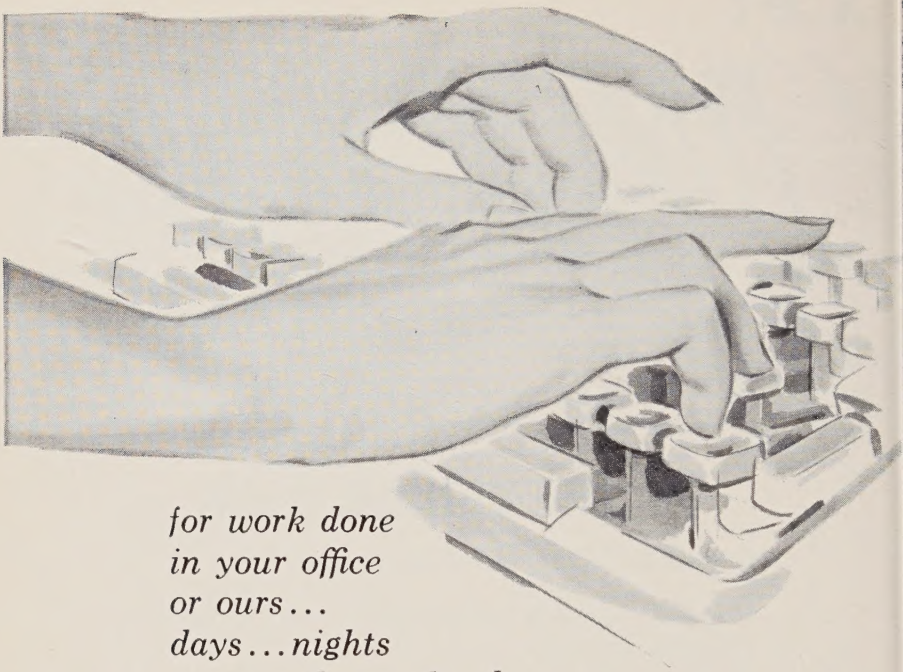

THE ILLINOIS

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PRESIDENT'S PAGE

By the time this issue comes to you, our Society will be well into another fiscal year; our new officers, directors and committees will be going forward with the Society activities into our fifty-sixth year. This "changing of the guard" takes place each year in early June, so smoothly and efficiently that it is probably not noticed by many of our members. I shall therefore take this final opportunity to say "I thank you" to everyone who supported our Society efforts in any way during the past year.

Although the Society presidency is a lot of work, and perhaps a bit more difficult for a local practitioner living away from Chicago, it is nevertheless a rich and stimulating experience. I have enjoyed it immensely and I know that I have gained much more than I have given during the past year. This is possible, of course, because so many loyal and able members are devoting their time and talents to Society work. I shall be grateful, always, for the privilege of sharing in these efforts, but most of all I appreciate the opportunity of meeting so many of the fine people who are members of the Illinois Society.

As I think back upon my Society experiences, I believe that our most important accomplishment over the past several years is the growth and development of a fine spirit of mutual respect and "togetherness" among so many of our members. This transition from the old idea that we are primarily competitors into the new concept that we are professional contemporaries has been brought about largely through our becoming better acquainted in Society work. These acquaintances soon ripen into friendships, and encourage tolerance, understanding, courtesy, respect, and all of the finer human attributes which should characterize our personal relationships, particularly those with our fellow members of our own profession.

Our success in achieving and maintaining a truly professional status in the eyes of the public depends heavily upon this matter of our attitude toward each other. We can hardly expect to achieve a great measure of public esteem collectively until we have first created a high level of personal regard for our contemporaries within the profession itself. Despite our God-given differences in temperament and personality, and the cold economic fact that we are in many instances in competi-

tion with each other, we are, nevertheless, actually partners in this most important common enterprise of our professional development.

Our professional organizations, the Chapters, the state Societies and the American Institute provide the means by which all of us can meet and know the people who are most interested in the things which are mighty important to you and to me. If you aren't getting the benefit of this fellowship and friendship, you are missing one of the best advantages of membership in your professional organizations.

Why stand alone? Plan now to show up at the next Society event and get acquainted with your "competitors." They're really fine people and I am sure you will enjoy knowing them better!

Cordially yours,

Audits of Special Assessments in the State of Illinois

By Donald S. Skinger

Under Illinois Statute (Chapter 24 Par. 1206) (Sec. 5) we find the following "The audit report shall contain statements that are in conformity with generally accepted municipal accounting principles, and shall set forth, in so far as apossible, the financial position and results of financial operations for each fund of the municipality." In view of the fact that this requirement applies with equal force to special assessment funds, the auditor should become informed of the statutory provisions as they apply to such funds.

The question that frequently arises concerns the auditor's responsibility in regard to the special assessment (local improvement) funds when he is engaged to make an audit of all funds of a municipality. In addition, the question usually further extends to the auditor's responsibility when he is engaged to make an audit of all funds, exclusive of the special assessment funds. This latter type of engagement is quite common, usually because of the inactivity, condition, or general misunderstanding of the nature of special assessments, and in many cases, the deplorable condition of the special assessments going back to the pre-depression years.

The question is avoided in a variety of ways. "These are dormant funds not connected with current operations." "The Treasurer is acting in a fiduciary capacity and these are not really municipal funds." "These funds are specifically excluded under the terms of my engagement," etc., etc. However, the municipal auditor should be particularly alert to see that special assessment funds are not used to cover a deficiency in other municipal funds. This would indicate that it will be necessary for the auditor at least to account for the special assessment receipts and disbursements for the period covered by his examination.

In those circumstances where the special assessment funds are to be omitted from the scope of the audit, the auditor must make a specific statement in his report to the effect that such funds were excluded from his examination. The auditor, however, must determine whether the exclusion of the special assessment funds affects the audit of other funds, primarily as to co-mingled monies, and the like.

In view of the foregoing comments it is considered preferable that the auditor make a limited examination

DONALD S. SKINGER, a member of the Illinois Society's Committee on Governmental Accounting (recently changed to the "Committee on Local Governmental Accounting") is a practitioner under his own name in Chicago Heights. The Auditor of Public Accounts of the State of Illinois has recently issued, through the Division of Municipal Audits, Bulletin No. 8 on the subject of "Special Assessment Funds."

of the special assessment funds, except in those cases where controls, records, etc. justify a regular general examination.

To account properly for receipts, the basic sources of cash must be explored:

(a) Current collections of principal and interest can be verified by reference to the assessments receivable records (original rolls) and samples (to be determined by the auditor) may be confirmed by direct correspondence with the taxpayer.

(b) Redemptions—These are of two kinds:

(1) Payments of past due installments of principal, interest and penalties in full. These amounts can be verified by reference to the publications of the delinquent special assessments (if published) and to the original special assessments receivable records. These are, except for additional interest and penalties, identical to the current collections referred to in (a) above.

(2) Redemptions by council action. These are usually old items which the council is anxious to clear up and as an inducement to do so will offer to waive accumulated penalties. These items can be verified by reference to the resolution authorizing the reduction in penalties.

(c) Foreclosures:

These items may be verified by examination of the court records or by examination of the county treasurer's records showing the proceeds of the foreclosure and the amounts remitted to the municipality. In many counties, confirmation of these amounts can be received directly from the county treasurer. While the allocation of foreclosure receipts as to principal, interest and penalties by warrants and installments is a subject within itself, the auditor again, as a minimum, should test the allocations to determine that they have or have not been properly made. Incorrect allocations generally result in the misapplication of cash receipts as between warrants and/or installments, thus improperly setting forth cash available for the redemption of outstanding bonds and/or vouchers.

To account for the fact that funds have been disbursed, reference should be made to the check stubs, cancelled checks, and bond principal and interest register. Any bonds or coupons paid in full should be examined. Further verification of these payments may be secured by direct confirmation with the bondholders. The propriety of disbursements to bondholders for principal and interest, either in whole or in part, again can be affected by improper allocations or distributions of foreclosure or regular cash collections. Generally speaking, if the propriety of disbursements cannot be determined by the auditor due to the condition of the records, errors made in foreclosure collection allocations, etc., disclosure should be made in the audit report.

The auditor, in his report, should specifically except the special assessment funds from his opinion, unless he has made an actual audit of such funds. Where separate audit reports are issued for the corporate (all other) funds and special assessment funds no exception would be necessary in their report, assuming an opinion could be given in each report. However, where the special assessment funds are covered under a separate report, it is recommended that a statement to that effect be made in the report of the corporate (all other) funds.

In conclusion, it would be well for all municipal auditors to keep in mind that most municipalities, special assessment funds are generally under the sole custody of the treasurer and, coupled with the fact that these funds are apt to be neglected from a viewpoint of accountability, improper use of these funds to cover other speculations is more than a remote possibility.

YOU-MANIZING THE PUBLIC DEBT

By James F. Stiles, Jr.

Accountants are used to dealing with long rows of figures preceded by the $ sign. Last January, I joined an establishment—the U. S. Treasury—that deals with one of the longest rows of such figures in the world: $275 followed by nine digits. That was, in round numbers, the size of the federal debt at the beginning of 1958: 275 billion dollars.

That debt, my fellow accountants, takes a bit of management. The United States Savings Bonds program plays an essential and important part in this by distributing the ownership of the debt widely among the people and lessening the amounts that have to be borrowed in less desirable ways.

It is surprising that so few of our fellow Americans are aware of the effect of the debt management policies and actions of the Government on their daily lives. Accountants, who live in the world of money, know the importance of the public debt in relation to the money market and its interrelationship with corporate, state and municipal borrowing. They know also about the importance of debt management as an integral part of the sound financing of our national government.

The Treasury's debt management operations must dovetail and fit properly with the budget and tax policies of the Government and the monetary policies of an independent Federal Reserve System. We shall consider these only briefly; many books have been written about each of them.

As to the budget, it is obvious that, if other conditions are favorable, it is easier to manage the debt properly when the Treasury is taking in more than it has to spend. Largely as the result of budget surpluses in the past two calendar years, the debt was cut from $281 billion at the beginning of 1956 to $275 billion at the beginning of 1958. For reasons which I do not have to detail for you, there is the prospect not of a surplus income this year but a deficit. The only way the federal debt can be reduced is out of surplus income over expenditures. Even when the budget is balanced, the Treasury has substantial cash financing to do in the latter half of the calendar year, when tax receipts are down—borrowing which can be paid off the following spring when tax receipts are high.

There have been only two sizable periods during the past decade in which the debt has been reduced, from the beginning of 1947 through early 1949, by $8 billion, and in 1956 and 1957, by $6 billion. Meanwhile

JAMES F. STILES, Jr., is National Director of the U. S. Savings Bond Division, U. S. Treasury Department, Washington, D. C. This article is adapted from a speech delivered at the Annual Meeting of the Illinois Society of Certified Public Accountants in Peoria, Illinois, June 5, 1958.

it had gone up and down and up again.

During 1958, about $55 billion in marketable securities, certificates, notes and bonds will have come due. Around $3 billion in tax anticipation bills will have matured. And about $22½ billion in 90-day Treasury bills will have to be "rolled over" not once but four times in the year. How would you like the job of refinancing all this when there will be no budget surplus but a deficit? You'd lie awake nights hearing the thud, smack, thud of debt falling due. With 254 business days in the year, it averages over half a billion dollars a day. Yet debt management rarely makes headlines and Mr. and Mrs. John Q. Public are blissfully unaware, for the most part, of what it means. When I think of that burden resting on Secretary Anderson, Undersecretary Baird and their aides in the Treasury, I am thankful that my responsibility is only Savings Bond sales promotion.

On the other hand, the credit of the United States is AA-1, and it is the biggest single business in the world. The latest issue of its securities was offered at a rate lower than the preceding one and was oversubscribed. I simply want to impress on you who are influential in money matters that the management of the debt is not just the responsibility of a few men in the Treasury, but everybody's responsibility. And I ask you to impress that on others in your business and private life. The Treasury needs all the help it can get, and more, from people who understand this.

One place where even citizens without special financial experience can be very useful and valuable in debt management is in the ranks of the volunteers who operate the U. S. Savings Bonds program to the tun of $5 billion a year in sales, with th assistance of a paid staff of only 55 covering the whole country. I repeat we need your help in this Saving Bonds program that is one of th foundation stones of a sound deb structure which, in turn, upholds an braces the entire economy.

Now how does the Savings Bond program fit into and dovetail wit debt management?

Whenever conditions permit, th Treasury must improve the structur of the debt by minimizing the type of borrowing that are most likely t lead to excessive credit expansio over the long run. Such credit ex pansion may often lead to a furthe depreciation in the real value of ou dollar. And, whenever we can, w must lengthen the maturity perio of more of the debt.

Let's look at the makeup of th debt. The latest breakdown availabl is for the first of March, when th rounded total was still $275 billion.

Of this, the banking system hel $82½ billion, or 30 per cent. Th Federal Reserve Banks held $23 bil lion. The commercial banks held $5 billion, and their share was 21 pe cent of the total debt.

U. S. Government investment ac counts—social security and othe funds—held $55½ billion, or 20 pe cent. These holdings are slowly in creasing through accrued interes and new purchases for these accounts

The rest of the debt, $137 billio or 50 per cent of the whole, is hel by private non-bank investors. Thes include mutual savings banks, $7½ billion; insurance companies, almos $12 billion; corporations other tha banks and insurance companies, $1 billion; state and local government $17 billion, miscellaneous investor not including individuals, $16 billio

Finally, we come to individual holdings, \$66½ billion in all Treasury securities, or 24 per cent of the debt. Of this, \$18 billion was in securities other than Savings Bonds and \$48½ billion was in Savings Bonds. This includes residual amounts of the "baby bonds," Series A through D, purchased prior to May 1941; considerable amounts of Series F and G, not sold since May 1, 1952; and some of Series J and K, also withdrawn from sale. For these series of bonds it is a case of everything going out and nothing coming in, with only the sale of E and H Bonds to keep sales up to or exceeding redemptions of all ten series of Savings Bonds, A through K. If we fail to do that, we lose ground in the important task of keeping the debt in the hands of individual citizens where it will do the least harm and the most good for the whole economy.

In Series E and H, the only issues now sold, individual holdings are right at \$42 billion in current cash value. That is just over 15 per cent of the total debt, and it is an all-time high in dollar holdings. That is good, but it ought to be better. With the total debt growing again we'll have to increase the holdings of Series E and H just to hold our own, percentagewise. As one Treasury official put it, we are in the predicament of Alice in Wonderland, who had to run faster and faster just to stay in the same place.

And here is where Savings Bonds again figure importantly. Selling these bonds is a sound way to manage part of the debt. For obviously the more Savings Bonds we sell, the less the Treasury must borrow from other sources.

There is another problem: the length of maturities in the debt. Frankly, too much of it is in short-term obligations; and as time passes, the maturity dates of course move nearer, unless you balance it up by selling intermediate and long-term bonds. In 1953, in 1954, and again in 1955, the Treasury made a start by selling intermediate and long-term bonds to refinance part of the debt as it came due. Further progress has been made during the last six months. But the mere passage of time operates to shorten up the debt.

With so much short-term debt constantly coming due (last year, April was the only month without a cash borrowing or refinancing operation) you can easily see that the Treasury is in the predicament of the legendary Greek king who offended the gods and was sentenced to roll a heavy stone up a steep hill only to see it roll back down, through eternity.

Lengthening out the maturities, while leaving enough short-term to meet the needs of the banking system and other holders of short-term funds, gives the Treasury room for planning ahead, and allows the Federal Reserve to conduct its monetary operations more effectively.

Savings Bonds come into this phase of debt management, too. For, although they are all redeemable, after two months for Series E bonds and six months for Series H, Savings Bonds are in actuality fairly long-term securities because most people hold onto them. It may surprise some of you to learn that the average life of Series E bonds (Series H has been sold for only six years) now outstanding is about seven years. I repeat, seven years. E bonds began to mature in May 1951. Of those that have matured so far, nearly 60 per cent are still in the hands of the original owners and growing in cash value each six months for an extra ten years after maturity.

Still another reason for selling Savings Bonds to more Americans is that this is the most effective way to spread debt ownership and keep it widely spread among the consumers upon whom our mass production depends for its mass markets. There are something like 40 million holders of E and H bonds alone right now, and that is almost a quarter of the people of the United States. This is good not only for the thrifty bondholders, but for the whole economy and the whole country, everybody. Regular saving (and we have about 8 million payroll savers alone who buy E bonds systematically and automatically) provides the substantial sums that are needed for down payments or purchases of the really worth-while things that raise the standard of living and maintain employment, sales and profits for business and industry and the whole inter-locked complex of production and distribution in our econmy of enterprise. Bonds have already provided funds to finance millions of homes, to buy cars, equipment for better living, comfortable retirement—you can finish your own list. Individual Americans have already used more than $60 billion of Savings Bonds money, most of it on the big things for better living.

Savings Bond holders are in a special sense owners of Shares in America, tangible evidence that we, the people, *are* the United States and the government, responsible for its management for our own benefit. That is the theme of our Share in America campaigns in 33 metropolitan centers and 200 other key cities this year, beginning May first. Strengthen your country's power for peace, prosperity and the pursuit of happiness, for the country belongs to you.

It is not contradictory to urge people to buy more Savings Bonds when others are urging them to spend more to check a recession. I assume that the United States will be in business for a long time and that we want to continue our capitalistic enterprise system which has been good to us and for us.

A country of expanding population constantly needs new capital to keep its productive plant and techniques abreast of the demand for more and better goods and services over the long haul. Real capital can only be created from savings, individual or corporate, accumulated by producing more wealth than you use immediately and putting it aside for the future. This depends upon enough people learning to save, acquiring habits of thrift and good money management. And these are long-run habits, not to be turned on and off like a faucet.

For seventeen years now, the E Bond program has been a tremendous booster for thrift, with its powerful and persistent plugging of the benefits of savings in Bonds or any other form. Americans have today tremendous reserves of stored up buying power in liquid savings—those that can be turned into cash readily without loss. That is a financial and psychological preventive of depression—around $300 billion worth of economic stabilizers, if you like. It is not our only safeguard, by far, but it is a potent one that needs to be encouraged.

Our bond campaigns, which importantly emphasize payroll savings promotions, are not aimed at making anyone save more than he should. But, each year now, around a million young Americans come to working age and are new and logical candidates for the payroll savings plan for

buying Savings Bonds. Many others who are regularly employed want to save and "just never get around to it." Furthermore, there are many others who see the value of a reserve in savings as a cushion during an economic downturn. The time for systematic saving is always NOW, not tomorrow.

We have had about 8 million payroll savers buying Bonds for some years now. Labor turnover, retirement and death, of course, constantly remove payroll savers from the rolls. We have to get companies to promote the plan periodically and also to sign up new workers as they go on the payroll, in order to keep the number we have.

Now, of course, I realize that in a period like this employers are very cost-conscious. We all are. You are accountants, and I am asking you to encourage your clients to install and promote the payroll savings plan. The question that immediately comes to your minds, as it did to mine (because I'm an accountant, too) is—How much does it cost to operate?

The answer is—very little. One to five cents per week per employee—or less than one-third of 1% of the average total annual cost of fringe benefits. Based on information compiled and published by the Chamber of Commerce of the United States, Table 7 of a 39-page brochure entitled "Fringe Benefits—1955," the average cost of all fringe benefits was 39.2 cents per man hour. Using the maximum cost reported of 5 cents per week, per employee, the cost would be approximately 1/8 of 1 cent per man hour to operate the Payroll Savings Plan. And for that tiny fractional expense, what is the employer giving his people? He's giving them a chance to build personal security—to save the easy way for emergencies and long-range opportunities—to invest in their country and thus become partners in the tremendously important job of public debt management. And the employer will have a thrift-conscious employee—need I say more—except that the U. S. Savings Bond is one of the finest securities in all the world. It's absolutely safe—it pays a good return—its tangible worth is always greater than the cost—it's a dollar bill with earning power.

The heavy demands of our times call for more than ordinary efforts, for the best that is in us. One way any responsible citizen can do his part is to do volunteer service in the Savings Bond cause.

For, as you well know, behind our military readiness to prevent aggression and attack, behind our projects for scientific progress, behind our plans for the conquest of space, must solidly stand a sound and stable expanding economy.

Peace in the world cannot be bought by dollars alone. But peace will cost money—the power to win it, the knowledge to keep it.

The strength of character to withstand the strains of the test we face is the indispensable ingredient. And that, to me, is the strongest reason of all for putting our hearts and minds and efforts into the long and arduous task of building our power for peace.

How a State Society Approached the Practice Management Problem

By David F. Linowes

More and more frequently, it seems, the profession of accountancy is pausing to explore how a different field—that of management—can be related to its own affairs. Specifically, the present paper indicates the state society's role in developing a better understanding of some of the problems involved.

To help put the subject in perspective so it may be approached by a regional professional organization such as a state society, first I should like to comment on the full meaning of the term "management." Management is more than just the act of controlling or directing. It includes responsibility for *creative* action. It goes way beyond passive reaction and adaptation, because it implies responsibility for attempting to *shape* the economic environment, for planning, initiating, and carrying through *changes* in the economic environment.

What does this mean to the accounting practitioner? It means that if the accountant manages his practice properly, he will not sit back and let the office run itself in the same old routine. It means he will assume the obligation of thinking about the planning for his office affairs so as to improve his level of earnings, his work-ing conditions, and his general pro-fessional stature and well-being.

Looking at management in thi light, it is clear that practice man agement is a subject of great concer to large, highly successful firm as well as to small, individua practitioners.

In a thumb-nail sketch sort o way, I shall attempt to analyze th functions entering into the manage ment of a practice—indicate wher a state society may act effectively— and comment only on the unusual ex periences of the D. C. Institute o CPAs where appropriate.

The management of a practic actually divides into three function Production; Administration; an Professional Relations.

The Production Function cover the assigning and scheduling of wor within an office, reviewing the wor upon completion, and setting o standards of performance—in shor getting the work out. A state societ cannot assist to any material exten in this phase of management, excep to serve as a forum to discuss the var ious problems in this field. Each in dividual firm or practitioner funda

DAVID F. LINOWES is a former president of the District of Columb Institute of Certified Public Accountants. This article is adapted from paper presented at the annual meeting of the American Institute of Certifie Public Accountants in October, 1957.

mentally must deal with its own production problems, relating the available personnel to the specific assignments on hand.

The Administration Function, however, is another matter. This covers relations among partners; employee relations, including educating, hiring, and training; office procedures; office equipment and supplies; and financing.

State societies can be very useful in helping with employee relationships and training. Through the local organized profession, cooperation should be established with schools of accounting to assist them in developing curricula of a type to be most beneficial to young people interested in the field of accounting, and incidentally, make better staff men upon graduating.

It also may be the medium through which American Institute training courses or any other professional training courses are brought home to the local practitioners.

What kind of office equipment to purchase to give the most efficiency and economy in a public accountant's office is of concern to many practitioners. To help here, the D. C. Institute held a Photo-Copy Machine Workshop. Six different photo-copy machines were displayed side by side, and company representatives were in attendance. The program was made up of a panel of accountants, each of whom has in his own office one of the machines displayed. Each panel member commented on why he preferred his machine over the others, and for what type of work he used it.

The workshop proved extremely helpful to practitioners in giving them an objective basis for comparing the highly competitive machines. But, even more, the discussions by the panel members brought out many suggestions for other CPAs to adopt in their own practices to improve their internal operations.

By way of side comment, we found in attendance at this workshop session a couple of members of our society who had not attended our regular meetings for years. Apparently, this type of workshop hit home the bread-and-butter way, and brought them out. A number of our members made their decisions to purchase a particular make of photo-copy machine as a direct result of this session. Also, some who had been planning to purchase a machine changed their minds after hearing the not too complimentary objective appraisals by other CPAs who already had the machine in their offices.

Salary scales, working hours and conditions, and on-the-job training programs are also administrative matters which may be treated effectively through workshops, sponsored by state societies.

The greatest field for a state society's assistance in practice management is through the Professional Relations Function. Professional Relations includes dealing with the public on the one hand—that is, Public Relations; and with the clients on the other—that is, Client Relations.

Public relations include participation in community activities, speaking before civic groups, writing and distributing articles which show how the CPA can serve, and in general getting the profession of certified public accountancy across to the public. This activity creates interest in the profession in general and in the participating CPA in particular. It helps a practitioner establish and develop contacts for building and improving his clientele.

Most state societies already take a leading role in public relations mat-

ters through their speakers bureaus and civic activities, in some cases with the aid of professional public relations counsel.

An interesting project undertaken by the D. C. Institute last year was the preparation and distribution of the pamphlet entitled "The CPA and His Government." This was prepared by one of our committees under the chairmanship of Winston Jones. The purpose of the pamphlet was to highlight the service opportunities now present for the CPA practitioner in Federal Government assignments. Various government agencies contract out some of their audit service requirements, and have found the use of the CPA practitioner highly satisfactory as well as economical. In this pamphlet, we also urge that more agencies use the services of CPAs on a contract basis, and it points up several governmental departments in which savings might be effected by contracting out their audit requirements rather than maintaining full time staffs of their own to do the work. Further, government agencies always seem to call for more capable accounting personnel than they have been able to obtain. Through this pamphlet, we urge the agencies to use the services of the many capable practitioners who do not care to become full time employees of the government, but would jump at the opportunity to take on an audit program on a contract basis.

The publication of this pamphlet resulted in excellent press coverage, and had a thought-provoking effect on many members of our society. As a matter of fact, I understand there are several local firms which are now actively preparing themselves for taking on these types of audit assignments, and are letting it be known amongst the agencies that they a available for this work.

In this way, our society has a tempted to bring home to the loc practitioners opportunities for pr fessional engagements which w might say are indigenous to our are

The other phase of Profession Relations deals with a firm's ow clients—that is, Client Relation Client Relations include such activ ties as analyzing a new engageme setting fees, how to bill, and natu and frequency of client conferenc These are the basic elements whi create the attitudes, atmosphere, an often affect the prestige of the pr fessional accountant.

In attempting to work in the ar of relationships between a profe sional accountant and his client however, we find a barrier whi must be pierced. A cold curta often hangs between an accountant fee-producing relations with his c ents and the outside world. Oft this curtain is drawn even tight when strange, unfamiliar accountan attempt to look over the shoulder the CPA and his client. Suspicio and unprofessional business compe tiveness and jealousies make it mo difficult to analyze effectively t weaknesses.

To move towards lifting this cu tain, last year the D. C. Institute CPAs first set about developing social program, in an attempt bring the professional practitione closer together.

All of the wives of members of o society were invited to a luncheo at which time the objectives of o program were spelled out. It w suggested that a Ladies' Auxilia be established for the purposes helping to get the CPAs to kno one another better—to help get t professional practitioners away fro

the business competition concept. The response was excellent; and, as a matter of fact, the Auxiliary started with a charter membership of ninety-three.

Immediately thereafter, a dinner dance was held—open only to members of our society. The tone set was one of informality and good fellowship, and it really broke down many of the stiff relationships among the local practitioners. Then, we knew we were ready to get to work.

On the heels of this social function, a Fees Workshop was held. The objective was for a frank, practical discussion of fees, how they are set, how billed, and related problems.

The format of the program was six panel members, plus a chairman. The panel was made up of one representative of a national firm; two representatives of substantial local firms; and three from smaller practitioners. Each panelist agreed to be completely frank and not evasive in discussing the fee policies of his own firm.

Most of the program was question and answer with audience participation. The subject matter covered billing bases, content of invoices, taking over a new account, adjustment of fixed fee job, and the varying levels of work performed by smaller practitioners.

There were three basic methods of billings in use by the practitioners; one, based on hourly or daily rate, that is, straight time; another method established a flat fee for the specific job; and a third method was a combination of factors based on time, complexity of work, and level of responsibility assumed. Although it was agreed that this latter method was the most desirable for determining fees on a realistic professional basis, it turned out to be the least used.

During the program, it was interesting (and somewhat surprising to me) to observe the widespread interest in what to put on the invoice sent to a client. Apparently, amongst the smaller practitioners, it is felt that the wording of an invoice is a very important phase of developing and maintaining proper professional relations with clients.

Four methods of invoice presentation were indicated to be in common usage: detail listing of hours spent and the rates; listing of work accomplished and fee for each phase; the word "for Services Rendered" and one amount; and finally a listing of the work accomplished and fee in one amount. It was generally agreed that this latter method is the most desirable, but here again it was not the most commonly used method.

Apparently, the approach in discussing fees with a client when taking over a new account is another area of concern to broad groups of practitioners. Some accountants seem to like setting as their fee for a new engagement during the first year the same fee charged by the previous CPA; others feel that on a fixed fee new engagement, a fee arbitrarily higher than the previous accountant's should be set, on the assumption that a change is being made because the client wants more and better service than he previously received. A large proportion of CPAs prefer to review the records of the client and establish either a minimum and maximum range, a minimum only, or a maximum only. It was generally agreed, however, that the best method of handling a new engagement, wherever practical, is on a time basis, weighted by the complexity and level of responsibility, without any commitment as to the fee until the engagement is completed. Nevertheless,

very few practitioners actually used this method.

At the conclusion of this workshop, it was evident that it was one of the most effective devices for helping CPAs clarify their own thinking and stimulate a re-examination of their own fee scales. It generated intimate fees discussions privately among accountants for many months; and it helped give the young CPA practitioner the kind of self-assurance a professional man needs, by the realization that all CPAs have the same basic day-to-day problems.

The aftermath of this one session was surprising. It triggered or planted the seeds for several developments worthy of mention of which I have personal knowledge.

One CPA rose to discuss his client-fee problems and the low level of accounting service required by them. He felt his qualifications and training were being wasted, yet, he did not know what to do about it.

In the same audience another CPA listened, but said nothing at the time. He realized that one of his own major practice problems could be solved if he would make use of the other accountants' services in connection with some of his more complicated assignments, thereby freeing himself for further development of his rather good practice. Within seven or eight months after this session, the two CPAs had become associated as partners.

In another situation, two partners who had been in practice together for almost ten years were impressed with the comments of a smaller practitioner who had been in practice for over twenty years and was still unable to upgrade his practice sufficiently to get away from the low income producing write-up jobs. These partners realized that they were being caught in the same unfortunate circumstances. They felt they could not afford to drop any of the low level work because of the financial requirements of their growing families. After considerable self-analysis during the succeeding months, the partners agreed that one of them would leave the practice, and he obtained a rather important position with the Federal Government. The remaining partner then had the freedom to screen the clients, dropping those which he considered inadequate.

Because so many of the members of the audience spoke at this meeting and the attitude was one of sincerity and frankness, for the first time many of us got a better understanding of the problems and capabilities and wants of our colleagues. This produced an unexpected trickle of client referrals among some of the practitioners. In one instance, a young man who was getting started stated that he was glad to take anything and did not care if he had to work on a reduced-fee basis. Subsequently he found that one well-established practitioner was delighted to refer a couple of clients whose service requirements were unprofitable to him in view of their fee capacity.

Another step taken by the D. C. Institute of CPAs is of significance in terms of establishing a state society's interest in the personal welfare of the individual CPA. We recognized that many practitioners are young men who have had a minimum of experience with CPA firms and then set up their own offices. Generally, the CPA experience of these young practitioners never touched on the many administrative problems confronting an accounting office. Yet these young men by the dozens set up their own offices, properly hold themselves out as CPAs, and

to a large extent because of their numbers, become recognized as *the* profession of public accounting in the eyes of the public.

These men undoubtedly are excellent accountants and know the technical aspects of our profession well, but know amazingly little about how to manage a practice. They do not know how to present themselves to the lay public as a professional man; they don't know how to negotiate with a client concerning work to be performed and fees to be charged. They do not know how to conduct relationships with members of other professions, or even with other members of their own profession. These are the day-to-day problems of individual practitioners in every community. Yet, when these problems occur, the CPAs concerned cannot wait for a workshop to be held so they can obtain some guidance there. These men may need help any day—and the kind of help they seek is important not only to the individual, but to the entire local profession.

To help in this area, the District of Columbia, as no doubt other state societies have done, set up a regular committee called the Practitioners' Advisory Committee. With substantial promotion amongst our members, we hope to make this committee a permanent committee of experienced and qualified practitioners, so it may serve as the arena for individual practice management problems of the local practitioners on a continuing basis.

In general, the state society is especially well suited to assist in areas dealing with public relations, intraprofessional relations, pointing up local opportunities for CPAs, sponsoring training programs, and establishing workshops for fees, equipment and personnel. State societies and chapters, however, may do another thing. They may assist practitioners in learning good management techniques.

Recognized authorities stress that management skill involves five basic steps: (1) Planning (2) Organizing (3) Assembling resources (4) Directing (5) Controlling. Constant repetition of basic points such as these through the publications and platforms of local organizations can do much to inculcate practitioners with sound management techniques.

You know the study of practice management is really the study of how to conduct a practice more efficiently. This, in turn, makes it possible for us as professional accountants to have the time and means to live broader, fuller professional and personal lives. It enables us to see beyond the edge of the fourteen-column worksheet into our own social and economic communities.

TAX COMMENTS

Conducted by the Committee on Taxation of the Illinois Society of Certified Public Accountants

STOCK OPTIONS REVISITED

The idea of giving an employee an option to buy stock in his employer corporation is not a new one, although it was not until 1950 when the "restricted stock option" device was added to the Internal Revenue Code, that the tax consequences of such an option could be predicted with any certainty.

Briefly, a "restricted stock option" is an option granted to an employee to purchase stock in his employer corporation at a price not less than 85 percent of the fair market value of the stock when the option is granted. Section 421 of the Code lays down various rules governing such options and provides that, if the rules are followed, no taxable income results to the employee when the option is granted or when it is exercised.

The restricted stock option device quickly became an extremely popular component in executive compensation plans, and the prolonged rise in security values up to July, 1957 created substantial paper profits for employees who were holding or who had exercised options.

At that point the option plans had performed very well the function of providing a long-range incentive to key employees to share in the future prosperity of their companies through appreciation in stock values. Few people visualized even the possibility of the drastic decline in security prices which has taken place since then—in many companies a decline of 50 percent or even more. In less than a year, key employees have seen options become worthless. Employees who exercised their options in whole or in part are in an even worse position. In some cases they are obligated to make payments for stock at prices substantially above market.

Two questions are presented by this development:

(1) Should something be done about it?
(2) Can something be done about it?

There can be no blanket answer to the first question. Whether something should be done or not depends on the purpose for which the particular option plan was adopted. No one would suggest that the proper purpose of an option plan should be to permit the employee to make a quick profit, or that an employee-stockholder should be protected against the vagaries of the stock market any more than the investor-stockholder who has suffered the same losses. Nevertheless, if the purpose of the original option was to provide a long-range incentive to key employees to insure the retention of their services, or to persuade a particular employee to accept employment by the company, and that incentive no longer

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exists because a drop in stock values has occurred through no fault of the employee or employees, then the answer may well be that something *should* be done about it.

What can be done? Two possibilities appear to exist: the company may grant new options or the existing options may be modified to relate the option price to current stock values.

To grant a new option, the company must go through the same procedures which it followed in the original granting. If a modification of an existing option seems more desirable than a grant of a new option, we are faced with the restrictions of Code Section 421 (e). That Section provides that the modification of an existing option shall be considered as the granting of a new option and that generally the fair market value of the stock at the time of granting of the option (i.e., time of modification) shall be the *highest* of—

(1) The fair market value of the stock when the option was originally granted;

(2) The fair market value of the stock on the date of the modification; or

(3) The fair market value of the stock on the date of any intervening modification.

Since the option price may not be less than 85 percent of fair market value, the requirement that the highest of these three values be used would bar any relief—except that Section 421 (e) goes on to say that this requirement shall not apply—

> "if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months before the date of the modification, extension or renewal, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension or renewal, whichever is the highest."

If this test can be met, the original fair market value may be disregarded in determining whether the option, as modified, qualifies as a restricted stock option. The Regulations [Reg. Sec. 1,421-4 (b) (3)] provide that in the case of stocks listed on a stock exchange, the average fair market value of the stock for any month may be determined by adding the highest and lowest quoted selling prices during that month and dividing the sum by 2. Although the Regulations do not describe any other method, it seems clear that other methods may be used. Whichever method is used must be used for all 12 months unless it can be shown that the method cannot be used for any month (e.g., an absence of transactions) or that the method does not clearly reflect the average fair market value of the stock for any month.

The following example may illustrate more clearly the application of this exception:

On February 1, 1956 a restricted stock option was granted to purchase 100 shares of stock of the XYZ Company at $85, and on that date the fair market value of the stock was $100 per share. The option has not yet been exercised. The option was modified on May 15, 1958, on which date the fair market value of the stock was $60 per share. The average fair market value of the stock for each of the 12 calendar months preceding May 15, 1958 was as follows:

May, 1957	$110
June, 1957	105
July, 1957	95
August, 1957	90
September, 1957 . . .	85
October, 1957 . . .	80
November, 1957 . . .	75
December, 1957 . . .	70
January, 1958 . . .	75
February, 1958 . . .	60
March, 1958	55
April, 1958	55

The aggregate of the 12 monthly average values is $955, and that amount divided by 12 equals $79.58, or less than 80 percent of the fair market value of $100 when the option was originally granted. Therefore, the option as modified on May 15, 1958 will qualify as a restricted stock option even though the new option price is as low as $51 per share—that is, 85 percent of the fair market value of $60 per share on May 15, 1958.

In the case of an option which has been more recently granted, it is noteworthy that there is nothing in Section 421 or the Regulations which requires the 12 month test period to follow the option granting date—for example, if the option in the example above had been granted on July 15, 1957, when the fair market value of the stock was $100 per share, it could on the same facts be modified in May, 1958, using the test period from May, 1957 to April, 1958.

Section 421 (a) requires that stock acquired pursuant to a restricted stock option not be disposed within 2 years of the date of granting of the option or 6 months after the acquis tion of the stock. In the event of modification, does this holding perio begin again on the date of the modif cation? Section 421 (e) provides tha *for purposes of Subsection (d)* modification shall be considered a the granting of a new option. Sinc the holding period requirement is i subsection (a), it is arguable that does not begin again. Neverthele the Treasury has indicated informa ly that its interpretation is that th 2 year period does begin anew on th modification date. The rationale ma be that the term "restricted stoc option" is defined in subsection (d and that therefore that term, whereve used throughout section 421, carri with it the implications of subsectio (e). It would seem that this kind c logic would render meaningless th phrase "for purposes of subsectio (d)." In a case where the point i significant, consideration should b given to obtaining (if possible) Treasury Ruling, before making disposition which might disqualif the option.

SOME WAYS TO IMPROVE YOUR AUDIT REPORTS

By Rosecrans Baldwin

Perhaps the best way to approach the subject of improving audit reports is to deal first with what I consider to be a bit of confused thinking that always seems to obscure the issues whenever the subject is discussed. Whenever these discussions are held, someone inevitably remarks that one way to improve a long-form audit report is to rewrite it from scratch every year so that each year's version will not be a stereotyped copy of the previous year's report. In other words, the report should look different every year, even though as a matter of actual fact the content is about the same.

I am not sure I agree with that premise at all. After all, a long-form audit report is a sort of historical reference work, and there is a great deal of virtue in using the same language to state the same facts in the same format in the report year after year. Otherwise the reader may suspect that important changes have occurred when in fact nothing significant has happened. Putting things in the same place each year also makes it easier to use the reports as a source of data. Many of our clients use our reports in this manner, and strenuously resist haphazard changes made more in the interests of adornment than enlightenment. So, at the outset I would like to express my disagreement with the idea of rewriting a report each year just so it will look different.

The above statement does not mean that the average audit report cannot be improved and should not be improved from the standpoint of content. The improvements which I think should be achieved, if our profession is to prosper, can be broken down roughly into three areas. I will take these up in turn.

The first area has to do with the general information about a company contained in an audit report, and the extent to which the report answers the reader's questions. I saw a report the other day on a building contractor in which was contained a conventional statement of cost of sales, showing opening and closing inventories, purchases, direct labor, indirect expenses, etc. It so happened that this company had had a fair year in 1956 and a catastrophic year in 1957. The operating statements in the audit report were rather detailed, certainly as detailed as one usually finds. For a certain type of organization they might have fitted the bill admirably, but in this case they completely failed to answer the question which any reader of that report was entitled to have, namely, how did the

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company happen to lose so much money in 1957? Actually, the loss was due partly to reduced sales volume, but for the most part resulted from a single fixed-price contract on which the costs got completely out of hand. Did the conventional cost of sales statement with which we are all familiar show this up? The answer was that it did not, and some other form of presentation should have been resorted to.

From the above illustration we can draw one moral on this whole general subject of how to improve our reports. It is simply this. When the financial statements indicate that there has been a tremendous drop in profit or a tremendous increase in receivables or some such unusual happening, think twice before producing a carbon copy of last year's report. Before releasing a report for perusal by bankers and other hard-eyed characters, make sure that it answers all the questions that need to be answered. Otherwise you will inevitably engender ill will in places where you can least afford to have it exist.

Along the same lines may I also touch briefly on what may be called superfluous and meaningless material in reports. An example of this is the report in which is included a schedule of, let's say, expenses for two years showing lots of details and lots of increases and decreases. Then in the text of the report, either adjacent to the schedule or elsewhere, the same increases and decreases are recited in flawless prose, in complete duplication of the information in the schedule. I have seen lots of this in audit reports and it represents the type of comment for the sake of comment which some auditors turn out by the ream. Therefore let our second commandment be always to review our reports to make sure that we are not saying in prose what can be stated far more clearly, concisely and completely in tabular form. Reserve your literary flights for explanations—not statistics. And never write comments just to fill space.

We now come to the second general area where a great deal ought to be done by the CPA, but which I suspect is often hardly touched. This is in the whole area of creative suggestion. We are always announcing in our Institute and State Society literature that we are capable of doing more for our clients than just audit their books. We act as their advisors. We are as good general business men as anyone else and are prepared to give our clients the benefit of our advice on all sort of matters, excluding, of course, specialties which are outside the field of our competence. I have seen a lot of these claims, and then time and again, when one of our staff men returns off a job, I ask him "Well what have we got to suggest to the client which will be of help to him?" The answer usually is a look of complete blankness, as if the thought had never occurred to him that during the course of his audit he was supposed to keep his eyes open for useful suggestions and tips of one sort or another which would help that client to do better. To be sure the average young senior will sometimes come in with some comments on loopholes in internal control, but these I regard as more or less a necessary evil from the standpoint of client relationships. Recommendations regarding the plugging of internal control loopholes are often unpopular with clients and at best may be accepted only passively by them. They are centainly not the type of things which make the clients get up on the housetops and cheer about the

constructive service they are receiving from their auditors. For example, if you were a client, would you be overwhelmed with enthusiasm for your CPA if all he could suggest to you was that your petty cash vouchers should be written in ink instead of pencil? It's hard to get fee increases with that sort of thing.

No, the type of recommendation I refer to is one which saves the client money directly or indirectly. For example, a report was recently issued to a client of ours that happens to have accumulated over the years a considerable amount of extra cash which it has invested in securities pending a decision as to what expansion program it should follow. During the time they have had them the securities have almost doubled in value, and so in this report it was suggested to the client that instead of paying cash dividends to the stockholders these securities could be used to pay dividends in kind thereby saving the capital gains tax payable on the appreciation. The client has received this suggestion and frankly is jubilant about the brilliance of our firm. He is equally happy about another suggestion that was made in the same report to the effect that he might wish to start a charitable trust fund for the purpose of handling the corporation's rather sizable donations to charity. This suggestion was particularly attractive when it was pointed out that some of the company's shareholders might also contribute to the same trust and derive some tax benefit from it. These two suggestions were submitted along with a number of others regarding internal control, including the time-worn chestnuts on voiding vouchers, taping cash receipts and the like, all of which fell on deaf ears by comparison with the two nuggets which were designed to benefit his pocketbook.

Please do not expect me to give you a list of one hundred profit making suggestions which you can pass on to your clients. If I had such a list I certainly would not let it out of my pocket, but as a matter of actual fact the key to the problem lies in that very indefinite realm which we call imagination. If you assign a man to an audit who has a lot of imagination or if you happen to be gifted with the same quality yourself, ideas percolate out of every engagement which either you or the man handles. Conversely, if you send out a man who is a technician and nothing else, the chances of his coming up with anything but the fact that the cashier handles the accounts receivable is virtually negligible. Unimaginative people simply don't imagine, and it is futile to talk about giving your client extra services unless you can first think them up. There are ways of stimulating this activity and we are trying some of them in our firm. Others can probably think of better ones. I merely state what I think are the facts of the situation. Solve the problem if you can.

On this same subject it is also my belief that constructive or critical recommendations and suggestions to clients ought preferably to be the subject of a separate report in every case instead of being incorporated in the regular annual audit. The situations that are being discussed are transitory in the sense that, if the client follows the recommendation, the condition ceases to exist. By contrast, the regular audit report is a historical document which sits for years in the files of the bank, for example. It should not be cluttered up with topical material that is usually of a procedural nature, and which

also might be embarrassing to the client. For this reason criticisms and suggestions should be submitted under separate cover.

By the same token, we usually favor putting our recommendations in writing instead of transmitting them orally. Suggestions made by word of mouth are often forgotten, or it sometimes happens that oral suggestions are pirated by the underling who receives them and who then perhaps presents them to the president of the company as his own ideas. Lastly, of course, there is the time-honored and completely valid reason for submitting recommendations on internal control in writing, so that the accountant will be "on record" in the event that a fraud develops later on. If the accountant can show that he had previously warned the client that the fraud was possible, his position is immeasurably strengthened.

We now come to the third general area to be discussed and this seems to be uncharted ground so far as most CPAs are concerned. I refer to the whole question of including graphic material in the standard long-form audit report.

For my own part, I have included such material in reports only on rare occasions, although we plan next year to start including charts in one audit report as a regular routine matter. I suspect that the reasons so few auditors have included graphic material in their output are partly inertia and partly the mechanical difficulties involved. In my case inertia is so definitely the answer, because our office has multilith equipment which can duplicate graphs just as well as it can duplicate typed pages. If we have not done more along this line it certainly is not because we do not have the facilities. As a matter of fact, the same applies to tho who do not have equipment in the own offices, because at relative modest cost one can have duplicati work done on the outside. To be su the multilith mats must be purchas (you can get them with graph lin already drawn on them) and drawi with special pens is necessary, b this is not a particularly insuperab problem. The main thing is to get out of one's chair and get goin Once you start I think that you w find that the mechanical proble can be easily and cheaply handled.

Supposing we do put charts a graphs in our reports, what form should they take? It seems to that outside of the conventional p chart in which the profit and lo statement for the year is present diagrammatically, graphic present tions can best be used when one presenting trend information for period of years. And here the o portunities for producing interesti charts are almost unlimited. For e ample, trends of sales, costs, inve tories, receivables, etc. can be sho remarkably clearly by graphic mea my own preference generally bei to use bar charts as opposed to li graphs. It is possible to obtain indu try and other averages from the D partment of Commerce and show th information graphically along si of the comparable figures for the c ents. Statistics can be developed such matters as numbers of person in various classifications, compar with compensation. Every client h its own peculiarities and the possib ities for utilization of graphs a charts must be considered for ea engagement in the light of the pa ticular situation. However, when is said and done imagination is t key to it. The first step, however, to brush away the cobwebs of t

past and actually do something instead of just thinking about it.

Before closing, let me quickly summarize once again my three areas and my thoughts regarding them. First, I do not believe in rewriting an audit report each year purely for the sake of saying the same thing in a different language, but by the same token I do feel that before signing off each year on a report you should make sure that the unusual situations that have occurred during that year and the questions which the figures themselves ask are clearly answered. Failure to provide these answers is one of the chief grounds on which accountants' reports are often criticized by outsiders. The second general area covers the submission of reports, usually under separate cover, in which we give the client that extra bit of advice and comfort which makes him look upon us as being more than mere nuisances who come in once a year to check his figures. Here the key is creative imagination. Without it there will be no results; with it you can make the client yours for life, not to mention the enthusiasm with which he will pay your bills. Finally, my third area has to do with departure from time-honored methods and the substitution of graphic presentations for tabulations. Here is virgin territory everyone of use can explore to his heart's content, but only if he is willing to overcome his own natural inertia and do some pathfinding.

Bankers and Accountants Relations – The Challeng of Substandard Reports

By Ted W. Johnson

It affords me an especial pleasure to be invited, once again, to talk before your fine group. I always welcome a chance to meet with my many friends in the accounting profession and the opportunity to discuss our problems and further avenues of banker-accountant cooperation. The last occasion was in Los Angeles in October of 1949. It was at that significant meeting, you will recall, that the doctrine of disclosure was adopted, requiring the accountant to express an opinion, qualify, or disclaim an opinion, which became the well-known Statement or Bulletin 23. This action was indeed a milestone in the history of the accounting profession and the Institute.

I should like to take these few minutes to review with you some ideas which have occurred to me on this subject of banker-accountant relations and CPA reports, and to conclude with a few comments bearing on the general subject of substandard audits.

Much fine work has been done between the National Committees of the AICPA and the RMA for many years. It is evident, also, that much work remains to be done througho the country for a better understan ing of our mutual problems and co structive activity in striving for eve higher standards in both profession The potentialities in these areas, i further support of our private ente prise system, are unlimited, and com paring our activities to date, with wha we could do is like comparing t waves of the surface of the sea wit the ocean's great depths. Marquis C Eaton, former National President the Institute, in his splendid articl "Financial Reporting in a Changin Society," which appeared in th *Journal of Accountancy* for Augu 1957, also set forth some very cha lenging objectives to all in the a counting profession.

In my report as retiring Preside of the Robert Morris Associates few years ago, I made this commen —and I believe it is as pertinent t both groups now as it was then: "Th broad and active work of the Ass ciates is and must be performed a the *local level.* Whatever may be th practice of respective Chapters wit regard to their excellent periodica meetings and regional conferences, i

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seems to me that, in addition, more emphasis should be placed on a continual, active program at the city or community level. Discussions and programs should be arranged so that there is constant thought, planning, and meetings at which opportunities are given for mutual exchange of ideas in each city where we have representation.''

In outlining such a program, I especially emphasized meetings with accountants in the interest of mutual improvement of relations, better audit reports, and sounder credits. The report stated ''Accountants and bankers are two very important members of the team of management. Tremendous good can be accomplished by close cooperation for the benefit of all, and especially the mutual client who, after all, is the one we are both working for and whose interests must be served at all times. Such meetings will result in both doing a better job. We, as bankers, will have less losses; we will do a more constructive credit job, because we will know the facts. The accountant will get more good audit business, with fewer problems and worries so far as the banker is concerned. And last, but not least, our economy will benefit.''

In these intervening four years, great strides have been made around the nation in the number of such meetings with the fine benefits which flow therefrom. In California this past year I have participated as a speaker in at least six different joint meetings (usually dinner meetings) of accountants and bankers in as many cities up and down the state, and much mutual good is continuing to emanate from these meetings, some of which represented the first time the two groups had ever met together. On several occasions I was accompanied by the President of the State Society, and each of us presented appropriate comments, prior to an active question period. I cannot stress too strongly the value of such meetings in your own areas.

Hear what one prominent Associate in an Eastern city wrote to me in this regard: ''Three years ago one of the active CPAs in our city and myself originated a local group, and gave it the name of 'The Banker-CPA Group.' We have held four meetings a year, and have limited attendance to ten bankers and ten CPAs. We do not have a Secretary nor do we take any minutes. Our meetings start at 6:00 p.m. with refreshments, followed by a dinner; then, from 7:30 p.m. to 9:30 p.m., we really take down our hair with each other and discuss our problems, an agenda of which is prepared beforehand. Our time is allotted on each subject, and we conclude promptly at 9:30 p.m. Subsequently, at the conclusion of the meetings, one or more small groups sit around for awhile and have what might be called a 'bull session' amongst themselves. We started these group meetings with various discussions on items on the balance sheet. It took three or four meetings before we completed the entire balance sheet and profit and loss statement. Another most important subject, which was very time-taking, constructive and informative, was the Accountant's Certificate. It was very enlightening to the bankers' group to learn of the many things the CPA Code of Ethics covered before they could use such phrases as 'generally accepted accounting practices,' and 'in accordance with procedures of the preceding year,' could be put into the Certificate.''

This banker-friend's letter goes on with many other interesting observa-

tions in connection with these meetings, but this will suffice to show the constructive character. My survey undertaken as a basis for this talk is very heartening, and reveals similar meetings on a wide scale all over the country; some more formal and some on a larger scale, but all with a common purpose. In a recent communication from Philip G. Moon of the National Bank of Detroit, and Chairman of the RMA Committee on Cooperation with Public Accountants, he states that joint activities of our two groups around the country are at an all-time high. In this connection, a splendid packet was recently sent out by the Institute to all members of the AICPA Committee on Cooperation with Credit Grantors and to Chairmen of State Committees of each state, in which there was enclosed material for use in arranging and furthering such joint meetings of accountants and bankers.

As one who has worked as a loan officer in the financing of industry for many years, and especially in financing and counseling growth companies, I well know, and I take every opportunity to impress on others in the banking business, the very great value, as an indispensable working tool, of good accounting figures and close relationships with independent public accountants. Certainly, I am sure you will agree that, likewise, contact by you accountants with the banker, as the ultimate principal user of your product, has real importance and value. As one individual, I am firmly dedicated to the continuation of such mutually-valuable relationship and to its further maximum improvement—to assist in my humble way in making a contribution, however small, toward this end—and that, gentlemen, is the only reason I am here before you today.

Into a loan man's mind, over the years, is seared this statement—"Get the Facts—or the Facts Will Get YOU!" A loan officer must need this advice or he is apt to have a loss. Too many losses—and he is out of a job. In making decisions on loans, like making decisions on anything else, wrong decisions are not so often mistakes of judgment as they are results of not having the facts. Good audit figures will help to get the facts and, many times, avoid a loss. Certainly those same words, "Get the Facts—or the Facts Will Get You!" are no less of importance to you in the accounting profession.

A very astute Northwest banker wrote me that "We follow a practice of requiring certified audit reports to accompany all credit applications from contractors (as a class) whether the account is new or already established. In such cases, recourse to the auditor is invaluable. I recall one instance where our guidance in this respect forced our client to adopt conventional accounting and audit procedures, which resulted in operations that were profitable, and which would not have been profitable without the accountant's services. The secret in this case lay in the client first ascertaining proper costs and then entering his bids in the light of the data provided."

Management decisions are based on financial figures, and hence management must be certain that such statements are reliable, otherwise faulty decisions will be made. The primary purpose of an audit, it might be emphasized, is not in order to borrow more money, but rather, as the illustration indicated, to assist the business to make more money. Your own and highly-regarded Executive Secretary, John Carey, in a talk given in California some months ago

put it this way: "Independent audits are no longer widely regarded primarily as a means of detecting errors and irregularities, but as a means of adding credibility to financial statements. It is the auditor's opinion . . . his acceptance of responsibility . . . that people are willing to pay for and, to a large extent, they risk their money on it."

An example of poor accounting and poor accountant relations, so far as the bank is concerned, is evidenced in a certain case which an Eastern banker friend told me about. The bank had a loan of a fairly-sizeable amount. The banker said he thought everything was going along nicely, when suddenly he found that the company had lost a substantial amount of money and a crisis resulted. The company had a CPA for some years, and in checking into the situation, the banker found, as he expressed it:

(a) *That this outside accountant, in his opinion, had tolerated incompetence in the office staff.* He really did not have a top accountant on this job, which was certainly a necessity due to the company's volume and problems, and the like.

As bankers, we like to feel that this is a responsibility of the outside CPA—to see that the client has a competent accounting staff. Obviously, this is also a means of keeping the auditing fees within reasonable limits; otherwise, the accounting firm has to go back and do practically all the bookkeeping to complete its analysis and make up the audit.

(b) *That there was no inventory control.*

It was three to four months before the banker finally got a good inventory. The basic records were poor and almost nonexistent, hence it was practically impossible to determine what the company's costs were or had been. My banker friend pointed out that he was, at the same time, being called upon to advance substantial sums of additional monies, running into six figures, to protect loans already made—and he didn't even have good inventory figures—he couldn't tell whether the company could make money, whether its costs were in line, etc.—a terrible handicap. Even with complete information the decisions would have been difficult enough, particularly as operating losses for the previous twelve months had all but wiped out the net worth.

(c) *That the accountant had led the management to belive that he was doing the work and carrying out his responsibility, but apparently this was not so.*

The accountant later explained that the owner of the business would not let him do the things that should be done; however, according to the banker, not only did there appear a lack of insistence on his part but, also, the accountant failed to set up and maintain adequate general accounting records in the company. Further, the banker stated, the accountant had frequently talked with the bank—but not once had he indicated to the banker that he was having difficulty in getting his ideas over or that the records were suffering as a result. The banker said that, to the contrary, he was led to believe that everything was satisfactory.

We all know that accounting is not an exact science, and that judgment and ability play an important part in decisions and conclusions; it, therefore, becomes very important to make a determination as to whose judgment we, as bankers, wish to depend upon—and this is where the

personal element comes in. As to those accountants who, by their actions, prove themselves to be incompetent or those who may continue to resort to substandard practices and audit reports—the only weapon the banker has is to pass them by, to refuse to accept their reports and refuse to recommend their services to other clients. I might add that a list is maintained by many banks and bankers of those whose audit reports have not measured up in this respect and who, so far as their reports are concerned, are "persona non grata."

Not very long ago, at one of the joint meetings of accountants and bankers I mentioned, an accountant came up to me after my talk and said that he was worried about a certain situation. He pointed out that he had been making up reports of a certain company for some three or four years which were not audits but actually were merely being taken from the books and records, for the client would not pay for an audit. He said that he knew the banker in the case was extending credit, but he, the accountant, felt certain that this financial report given to the banker was incorrect; he also knew that the borrower had been telling the banker that the money he was borrowing was needed to meet the payroll, when in fact it was being used to pay past due taxes. The accountant told me that his conscience was bothering him, and that unless the banker raised a question this year he felt he could no longer continue making up the report and would give up the account. He said that he had hoped and actually prayed that the banker, somehow, would read and understand the disclaimer—realizing it was not an audit—and thus proceed to inquire into the facts, possibly correcting the situation before it was too late. The accountant emphasize that in this manner the banker woul not only be helping himself, but als conceivably saving the business fo both should it be desirable. It is apparent from this and other actua instances that much also remains t be done insofar as the education o the banker is concerned, particularl in the smaller banks, in furtherin his knowledge of audit forms, procedures, responsibilities, accountants terminology, etc. A careful study o the splendid booklet recently prepared by the Institute, entitled "4 Questions and Answers about Audi Reports," would be most worthwhile in this connection.

Times have been too good the las fifteen to twenty years. We've probably all gotten too careless. Banker have not been as technical, or hav not tended to analyze trends as carefully as in the past. We haven't ha to! I am sure, also, that banker have been more willing to accept figures which were not properly audite or reports which have not been to well done, to say the least.

At a recent meeting of the Rober Morris Associates Chapter in Lo Angeles, this matter was discussed It was agreed that bankers undoubtedly have been negligent in this respect. It was also considered essentia that from now on we should be mor careful, more selective, and pay mor attention to and insist on good audi figures and reports.

Very often the question properl arises as to the ethics and propriet of a banker asking the accountan for pointed information without th express approval of the client. It wa suggested by an accountant whom know that bankers incorporate a provision either in their statement form or by getting a separate authority a the time a loan is made, authorizin

them to talk with the accountant at any time about any phase of the business or the statement figures. I would suggest, here, the advisability of obtaining at the same time a letter or order to this effect, directed to the accounting firm, so that the accounting firm would have something in its files for the record. The accountant and banker should always be on a personal basis, and, as bankers, I feel we all have a right to expect the accountant to work with us—and I am sure that this is so.

There is one other subject about which I should like to talk with you today, and that is substandard audits.

I am sure you will agree that, over the years, as a result of our close cooperation and interchange of ideas between accountants and bankers throughout our country, and particularly between the State Societies, the Institute and the Robert Morris Associates through their standing Chapter and National Committees much good has resulted to our banks, to the accounting profession, and to our economy. Further, greater strides forward would now be possible if a method could be found to encourage greater compliance with auditing standards and thus reduce to a minimum substandard audits.

I am authoritatively told that today one of the biggest problems confronting your profession is the prevalence of these substandard audits. The Institute's Committee on Auditing Procedure has, over the years, established high standards for auditing—yet, despite its bulletins and case studies, I am told there is increasing evidence that CPAs, in too great a measure, are not adhering to these principles. We mean, of course, "substandard" due to carelessness, indifference, or lack of capacity of the accountant.

Obviously, a subsidiary issue to this problem is that of discovering ways of bringing more of these cases into the light of day, as a result of which, perhaps, constructive disciplinary action might be taken to bring about compliance with standards. The reticence of bankers, credit grantors and other third parties to reveal substandard auditing to the State Committees of the State Societies or to the Institute is natural—but unless, somehow, a workable and sound plan is developed in this respect, progress toward enforcing compliance in these many cases will be slowed considerably, if not brought to a standstill.

All of us, of course, are aware of the technical and possible legal ramifications of this over-all subject, but certainly these should not deter us from constant review and discussion and exploration of the problem in all its facets. If a solution is reached, or if even only some additional steps forward are taken at this time, it is widely acknowledged that it would be one of the greatest constructive forces in our generation for further advancement of the profession.

As indicated, this is a subject which is in the forefront of your Institute and its national officers and your State Societies and, of course, is of great importance to bankers generally. For these reasons, I thought you might be interested in a few observations I was able to get together in anticipation of this talk today. In my limited time I can present only a few of the reactions received, and, I submit, these expressions of opinion are only for your consideration—you and I may or may not agree with all the thoughts expressed, but some may have merit.

Listen to what one authority, an outstanding financial advisor to busi-

ness, and who, incidentally, has a long and successful background in accounting and as a CPA, had to say: "The Institute cannot expect the banks to be the sole enforcer and policeman for audit standards. The accounting profession, in my judgment, will never get anywhere in this matter of policing until it takes on this responsibility itself, along with banks and other credit grantors. This could be done by establishing a committee on a national basis, as well as a statewide basis, or even on an area basis. This committee would be delegated with authority to make a constant review of audits and audit standards, with the express objective of locating and reviewing substandard audits and bringing constructive disciplinary action where necessary. This committee would have to have, by agreement, the right to pick out certain accounts from the different CPA firms and review the audits, as well as audit systems and practices of that firm. They should have a right to discuss with bankers any questions that might arise, all on a confidential basis." This authority went on to say, "It is the practice of large national accounting firms to have traveling audit teams step into the various offices of their firms and review their methods, policies and systems, and expressly examine audits made, looking at them as of a subsequent date when they have the benefit of hindsight. In this way, they keep an overall policy in effect, as well as standards, which at the national level the partnership members lay out." I could not help thinking at the time that there may be some comparison here, however remote, to the examination and disciplinary action involved in the examination of banks by the National Bank Examiners identified with the Comptroller's Office, and a parallel to the setup of the Stat Banking Department involving Stat banks. These Examiners, of course have the right to go into the membe banks for regular examinations t detect weaknesses, bad practices o policies, or substandard loans. Th more one thinks of this problem, i seems there could be the germ of a idea here worthy of further investi gation and consideration. The publi interest is certainly concerned i both instances but, of course, to much greater degree in the case o banks, Some, undoubtedly, woul take exception to the right of an such committee to delve into the re ords of a CPA firm, and perhaps thi might be impractical; and, as some one stated, it is not "the America way," especially in the absence of a actual complaint being filed. Even i this event, perhaps the recours should be only by a hearing, in whic the accountant would submit hi papers as a part of the proceedings o the hearing. Obviously, we are n attempting, nor do we have the abi ity, to outline or pinpoint any specifi plan, but merely to challenge th thinking of all of us in the directio of this important problem.

Here, again, on this matter of en forcement of standards, listen to senior statesman in your professio "This matter of policing is basicall the accounting profession's job. start could be made from reviewin audit statements that are available t the public, which would include ex tensive reports submitted in connec tion with SEC applications and othe reports; bankruptcy records wher audit reports were made a part of th record; reports to stockholders wher copies of the audit might be submi ted to each stockholder; audits in volved in connection with officia State documents or court procee

ings, where such statements might be submitted in evidence. These," he continued, "would furnish at least a good starting point for the activity of the enforcement division."

This authority went on to say that he understands, from legal counsel, that "The owner of an audit report, being the one for whom the report is made, is privileged to give the report to anyone he may wish without criticism or liability to the accountant who made it up. Banks, of course, come into possession of their figures in this manner. Any third party receiving an audit report, and this would of course include the banks, would not be privileged to pass on the report without the approval of the owner thereof, or at least in doing so, without some liability, possibly, accruing; in other words, in the event of a substandard audit report, the banker certainly could pass it on to the enforcement committee without any liability, provided he had the approval of the owner or, in this case, the borrower. Under such circumstances," this accountant told me, "it is felt that the approval would be forthcoming, and in many instances the banker could get the owner to submit the report to the enforcement committee and by-pass the bank."

The opinion was also expressed that when and as procedure is set up for such enforcement of standards, others will voluntarily bring the reports to the Society's attention for the correction and benefit of standards generally. "A vigorous, operating enforcement procedure," he reiterated, "would be a truly great step forward." This senior CPA concluded his remarks with the statement, "One of the greatest forces in our lifetime for developing more-or-less minimum standards has evolved in the case of accountants' reports required in connection with the sale of securities, calling for full public disclosure of all facts by the applicant. This has had a most beneficial effect, and has raised the standards of the accounting profession in the United States to a considerable degree." He went on to say, "If this problem of enforcement could be worked out, it would be an equal if not greater step than any heretofore taken."

Another thought on this subject—a further source of development of substandard audits could well be from information furnished from the follow-on accountant. This would be applicable where the accountant has been changed, for one reason or another, perhaps as a result of the insistence of the banker. The follow-on accountant would have the opportunity to review the work of his predecessor and, if not up to standards, to turn in the information to the proper Committee of the State Society or the Institute for constructive disciplinary action. If the banker is being asked to participate in bringing to light substandard audits that might pass over his desk, certainly it is to be expected that the accountants should have a similar sense of responsibility to report on their fellow accountant where knowledge of such substandard work comes to them. I full well realize there is hesitancy or reluctance here also, but it seems to me that the obligation on the part of the accountant to do this is even greater than that of the banker—but, again, both have mutual interests.

In any discussion of this subject of making available possible substandard audits to the appropriate Committee of the AICPA or State Societies, the question of legal responsibility always arises. As I see it, the situation need not call for the

banker to be in a position of the "star witness for the prosecution," but rather, the determination as to substandard is purely a factual matter—does the report meet the standards of the profession, or doesn't it? The banker is not making any charges—he is not being called upon to make the determination—neither is he, in most instances, qualified to do so. Is he not just presenting the report for analysis by a jury composed of accounting experts? It is they who would reach the verdict and determine whether they deem it necessary to take further disciplinary action in the event of substandard workmanship. The banker may have an idea, but need not take a position, in submitting the report which he considers to be substandard, but merely call for an expert analysis.

Questions involving public relations, or claims that the bank might be "snooping," could possibly be overcome, in a large measure, if and when in your wisdom you might see fit to incorporate the equivalent of Statement 23 into your rules of professional conduct; in other words, as individual, professional members of the Institute, you would have laid out the ground rules—and, in effect, you would have "asked for it." Even under these circumstances, for the purpose of submission of any audit, of course, the bank would expect to get the approval of the borrower, so that it would not be passing along confidential information and thus violating its confidential relationship. It would seem that this would give you the tool of enforcement, when and as you really become of the mind to use it.

In discussing this subject with a prominent attorney, he confirmed this line of thought and expressed the opinion that there would appear to be a large area in which the bank could work with the accounting profession in this matter of raising substandard audits. He felt there would be no liability on the bank or banker if he were to select an audit and, in effect, say to the Standards Committee of the Society that, "Here is an audit—we wish you would look it over and determine for yourselves whether it is substandard." In other words, this attorney emphasized the point that if, as a bank, we make certain representations which may not be true, then we assume some responsibility; however, in such an instance as indicated, where we make no representation but merely submit it to the Committee for consideration, the bank, then, would be assuming no liability. Of course, we would, as indicated, have received the approval of the borrower to such action.

I should like to conclude these remarks by paying high tribute to each of you, to your fine Association, and to the accounting profession in general, for the outstanding record you have made and the high standard attained. It is almost unbelievable that within our lifetime, statements, audits, have become of general use and are now generally speaking, a strict requirement in many transactions in our national commerce, including a prerequisite for bank credit.

You can well take pride that the standards of your workmanship have shown a continuous rise, and in the survey I undertook, bankers nationwide reported an upward trend in the quality of reports they were receiving in their banks. Obviously though there is much more that can be accomplished toward making these standards even higher, and especially in this area of substandard workmanship, as well as broadening the use of audit reports.

We all know that the problems here are many and varied, including, to be sure, some differences of opinion among your own members, but this must not deter us from trying to find solutions, but rather, stimulate all of us to the challenge—also, I can assure you that in your continued endeavor to solve these problems you can, as always, look to the full support of the Robert Morris Associates and your banker friends throughout the land. I am certain that there is a large area in which the banks can work with the accounting profession in this matter of policing substandard audits. Further unbiased, objective and unhurried consideration of all factors, I am sure, will assist in finding the answer.

TAXES MAY CUSHION THE EFFECT OF LOSSES

By Mary C. Gildea

We think of losses cushioning, or reducing, or even eliminating taxes, but if there is a loss how can it be made less a loss by taxes? And yet there are provisions in the Internal Revenue Code which, while not entirely curing losses, can act as sedatives and lessen the pain somewhat. These comments will be primarily concerned with one type of such sedation, the use of net operating loss deductions.

Business, by custom, operates on an annual accounting period; government budgets are set up on an annual basis; and the tax structure is also designed with an annual accounting motif. In the main, business finds this a fairly reasonable measuring stick, since a year's operations will include the seasonal fluctuations. However, there are some businesses which, because of their nature, do not have such a fairly stable operating period, or their cyclical fluctuations may cover longer periods than can be encompassed within one year. The net operating loss provisions of the income tax law were put into effect largely to even out the tax burden of such enterprises.

Pressure from business, as it commenced to recover from the loss years of the thirties, also influenced Congress in writing in loss carry forward provisions into the 1939 Code The boom created by World War I brought other questions. Would ex cess profits taxes and renegotiatio proceedings leave a sufficient surplu to overcome losses created by can cellation of war contracts? And s the 1942 Act provided for a carry back from loss years to precedin profitable ones. Various terms ha been used as the period covered unti the 1954 Code provided for a carry back of losses to two preceding year and a carry-forward to five subse quent years, which is still the law today.

Under the 1939 Code and the Act amending it, the theory underlyin the allowance of a net operating los was that it should represent an actu economic loss as contrasted with tax return loss. Thus, there were ad justments in both the year of los and the year of deduction providin for the elimination of special treat ments which made the tax return in come less than the actual economi income. These adjustments related t tax-free interest, dividend credit the excess of statutory depletio charges over depletion on a cost ba sis, adjustments of capital gains an losses, and—in the case of individual —the elimination of the personal ex emptions. While the theory wa

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simple, the execution provided difficulties. This may have been because taxpayers did not always read carefully and apply accurately the specific rules relating to these adjustments. There also arose the feeling that these provisions created discrimination between taxpayers averaging out income between loss and profit years and those taxpayers who showed a more stable profit picture. This attitude is clearly shown by the report of the Senate Finance Committee on the rewriting of this part of the Code.

The intention of Congress may have been the laudable one of eliminating discrimination. Tax practitioners can thank them for achieving some degree of simplification.

There may be some cases open covering years prior to 1954. If any net operating losses are involved, the amounts of the losses, the deductions, and the carry-overs must be computed under the law applicable to the taxable year involved. Most of the interest at the present time, however, is in the provisions of the 1954 Code.

The definition of a net operating loss in the Code is very simple. It is "The term 'net operating loss' means the excess of the deductions allowed by this chapter over the gross income." However, the next sentence reads "Such excess shall be computed with the modifications specified in subsection (d)." That is where distinctions must be made.

For a corporation the modifications are:

1. No deduction shall be allowed under Section 242, relating to partially tax-exempt interest;

2. No deduction under Section 922, relating to Western Hemisphere corporations;

3. The deductions for dividends received shall be allowed without regard to 85% of net income limitation; and

4. The deduction allowed by Section 247 relative to dividends paid on certain preferred stock of public utilities shall be allowed without the limitation based on the taxable income.

After giving effect to the foregoing modifications, the net operating loss figure so determined becomes, without change, the deduction to be carried back to the second preceding year. However, in determining whether there is any excess to be carried forward to another year, the same adjustments must be made in the year of deduction as were made for the loss year. That may sound confusing, but perhaps an example will clarify it:

Let us assume that a corporation had a net operating loss, after the adjustments, of $150,000.00 for 1957. In 1955 it had a net income of $200,000.00 which included $100,000.00 in dividends and a deduction of $25,000.00 for partially exempt interest, thus showing a net taxable income of $115,000.00—the $200,000.00 less the 85% dividend credit. The carryback of the $150,000.00 from 1957 would, of course, eliminate all tax for 1955. The amount of net loss carry-over to 1956, however, would not be $35,000.00, but would be computed as follows:

$200,000.00 net income plus $25,000.00 tax free interest deduction less the $85,000.00 dividend credit, or $140,000.00. This subtracted from the $150,000.00 net operating loss carry-back would leave $10,000.00 to be applied against 1956 income.

These modifications give rise to

some rather odd and interesting situations. A corporation may have an accounting income and at the same time a net operating loss carry-back. This is particularly true in that twilight zone where the dividends are more than 85% but less than 100% of the net income.

An individual may also have a net operating loss deduction if the loss was sustained in a trade or business. In the case of an individual, some of the modifications are self-explanatory but others need amplification. There is not much difficulty in understanding the elimination of personal exemptions, the ban against including a net operating loss, or the eliminations of the 50% credit against net long-term capital gains.

Non-business capital losses cannot exceed non-business capital gains, and business capital losses cannot exceed the sum of business capital gains and non-business capital gains. The result of these limitations is that no net capital loss will be considered, whether it is a business or a non-business loss.

Ordinary deductions which are allowed for such personal items as contributions, interest, taxes, and medical expenses are to be offset against non-business income such as salaries, dividends, and so forth. If the result is an excess of deductions, the whole thing is eliminated in the calculation of net operating loss; if the result is an excess of income, the amount of that excess is to be added to the business income. The only ordinary deduction which is taken out of this computation is a non-business casualty loss. By special provision this item is treated as a business loss.

Any gain or loss on property used in the trade or business is to be taken in at the full amount, not treated as a capital gain or loss. This would refer to real property used in the trade or business or business property which is subject to depreciation.

In the case of a husband and wife the joint net operating loss for any taxable year for which a joint return is filed must be computed on the combined income and deductions and the modifications are also to be computed on the combined income and deductions.

The question of capital gains and losses can become somewhat bothersome, particularly where there are capital loss carry-overs from prior years. However, the examples given in the regulations are very clear and should be consulted in any such situation.

By special provision, there is no recomputation of contribution limitations in the year in which the loss is deducted. If a net loss suffered in 1957 is carried back to 1955, the deduction for contributions in the recomputation of the 1955 tax will remain the same as was permissible under the original return. However this does not apply to medical expenses or to the standard deduction. These will have to be recomputed, which may result in a larger medical expense deduction and it may result in a small standard deduction. If it does result in a smaller standard deduction it may be beneficial to change to itemized deductions.

If the loss is not fully absorbed in the year of deduction, additional modifications must be made to determine the amount to be carried to another year. These modifications include the resetting of the first year of deductions by elimination of personal exemptions; elimination of the 50% reduction of net long-term capital gains; elimination of net capital losses; and recomputation of percentage

limitations, and in this case the recomputation includes contributions.

Again, reference to the regulations discloses some very carefully worked out examples.

A partnership is not allowed to deduct a net operating loss but the individual partners can use their proportional shares of any loss to determine if they are entitled to such deductions.

An estate or trust may have an operating loss deduction with the modifications applicable to an individual and with these further limitations: the elimination of income and deductions attributable to grantors and others treated as substantial owners; the elimination of a trust's special provisions relating to charitable contributions and to distributions.

In addition, if there is any unused net operating loss deduction at the termination of a trust or estate, such unused portion may be transferred to the beneficiaries.

Some of the most bothersome—and most interesting—aspects of net operating losses are those relating to successor or acquiring corporations.

Prior to the enactment of the 1954 Code, there were no statutory provisions relating to carry-overs from one corporation to another. There were numerous cases which had been adjudicated by various Courts, including the Supreme Court of the United States. Nevertheless, there was confusion since each case was settled on specific facts and taxpayer corporations were, naturally, always trying to find new avenues of approach. Congress tried to correct this chaotic situation by writing Section 381 into the Code.

Section 381 permits carry-overs to the following types of successor corporations:

(a) a parent after complete liquidation of the subsidiary providing the subsidiary's stock was purchased by the parent more than two years before the liquidation;

(b) a parent corporation which had acquired the properties and assumed the debts of a wholly owned subsidiary in a tax-free liquidation under 1939 Code Sec. 112 (b) (6);

(c) the transferee in certain specified types of non-taxable corporate reorganizations.

The carry-over provisions do not apply to partial liquidations, to split-up, split-off, or spin-off types of reorganizations. There are certain rules and regulations governing the use of these carry-overs by transferee corporations which must be studied and followed carefully. There is also Section 382 which provides for "Special Limitations on Net Operating Loss Carryovers."

The main provisions of Section 382 may be divided into two categories, those relating to the purchase of stock in a corporation, and those relating to continuity of the business of the corporation.

Section 382 (a) relates to the purchase of stock in a loss corporation. It provides that if ten persons (or less, if there are less than 10 stockholders) who own the largest percentage of stock in the corporation had increased their ownership by 50 percentage points or more during the prior two years, this shall meet one of the requirements for disallowance of the loss carry-over. The increase in ownership is to be counted only if it is by purchase of stock or by a decrease in the outstanding stock. The 50 percentage points of increase does not refer to percentage of increase of the holdings of the individual stockholders, but to the percentage of the outstanding stock of the corporation. Consequently, if the ten

largest stockholders do not, at the end of the qualifying period, own a total of 50% of the corporation stock, the rule would not apply. It must be remembered, however, that the number of ten can be enlarged in two ways: First, if some stockholders own the same number of shares as some of those in the first ten, they also must be included, thus increasing the number; second, by applying the attribution rules of constructive ownership.

The other test under Section 382 (a) is that of continuity of operation. The carry-over will be disallowed if the provisions of the 50 percentage points increase are met and if the corporation does not continue to carry on substantially the same trade or business as before the change in stock ownership. There are no regulations to date defining what will be considered as substantially the same trade or business. We can only refer to the Committee Reports to ascertain the intent of Congress in enacting this provision, and the wording is not specific. It states only—"If, as a result of such an increase, the corporation shifts from one type of business to another, discontinues any except a minor portion of its business, changes its location, or otherwise fails to carry on substantially the same trade or business as was conducted before such an increase, then the condition in subparagraph C is met." That quotation was from the Senate Committee report. The Conference Committee report amplified the meaning slightly by stating: "If the corporation continued to carry on substantially the same trade or business, the limitation would not be applicable even though the corporation also added a new trade or business."

Reading the law as enacted an reading the Congressional comment still leaves many questions to be an swered. Taxpayers who are consider ing acquiring loss corporations ca only be advised to proceed wit caution.

There is another provision of Se tion 382 to which attention must b given. Subsection (b) relates to limitation on net operating lo carryovers in cases of reorganizatio under Section 381 (a) which we hav previously discussed. Briefly th provides that the stockholders of th "loss" corporation must own, imm diately after the reorganization, a least 20% of the fair market valu of the outstanding stock of the ac quiring corporation. If the owne ship is less, the net operating lo carry-over will be reduced propo tionately to the amount that th ownership is less than 20%. In othe words, if the ownership is 15%, th carry-over will be reduced to 75% o its original amount; if the ownershi is 10%, only half of the carry-ove will be permitted.

Writers and commentators on ta matters have presented many idea as to the possible difficulties wit these provisions, and also ideas a to possible loopholes. All of it, how ever, can be summarized as follows

> In any case where there is to be a acquisition of a loss corporation or a r organization or other combination i which a loss corporation is a part study carefully the Code, the Committ Reports, and any other material avai able; analyze the situation fully, an try to determine the pitfalls and adva tages under various methods of handlin taking into consideration the particula facts involved. And don't forget Co Section 269 which still permits the Go ernment to disallow tax advantages acquisitions which are presumed to merely for the purpose of evading avoiding income tax.

While this discussion has been confined to net operating losses and their use in reducing the tax burden of profitable years, there are other allowances for lossses such as those for lossses by storm or other casualty, by theft and embezzlement, and even those caused by illness in the guise of medical deductions and sick pay allowances. By permitting the use of such items to reduce the tax liability, the Government shares with the taxpayer some of the loss incurred.

During this period of diminishing and vanishing profits, it is extremely necessary for management and for the tax practitioner to be aware of the various means of using losses to offset tax liabilities, and to obtain refunds on taxes paid in previous years. The timing of expenditures and the necessity of retrenchments might well be affected by the possibility of a partial relief through refunds of taxes previously paid. The tax practitioner can be of great service to his clients by a careful review and analysis of their operations with these tax benefits in mind. But, in spite of this fraternal sharing of losses by means of tax benefits, both as tax practitioners and as taxpayers we should remember it is still better to have profits and income even though we have to pay the tax on them. No matter what the tax advantages, it is still a fact—if I may paraphrase Gertrude Stein,—that a loss is a loss is a loss.

ACCOUNTING FOR STOCK SUBSCRIPTIONS IN ILLINOI

By Paul W. Clevenger

The problem of accounting for capital stock subscriptions arises in part because of the unique quality of consideration necessary before shares may be issued. In an ordinary sales transaction, a corporation is free to transfer the purchased asset to the vendee upon the vendee's promise to pay sometime in the future. Capital stock, however, may not be *issued* until it has been fully paid for in "money, in property, tangible or intangible, or in labor or services actually performed for the corporation . . . Neither promissory notes nor future services shall constitute payment, or part payment, for shares of a corporation."[1] These restrictions do not prohibit stock subscriptions but do attempt to defer the enjoyment of shareholders' rights until the necessary type of consideration is paid in full. The evil at which this provision is aimed is the issuance of capital stock upon "paper promises," a practice which may constitute a fraud upon creditors and other shareholders.

Even though a subscriber may not be said to be the legal owner of shares, he does have certain explicit rights. He may complete payment and become a shareholder, or he may default in payment and seek restitution of the amount paid into the corporation. This latter right is spe-fically provided for by statute.[2]

In view of these facts, the proble then arises as to what accounti entries should be made by the co poration accepting a subscripti adequately to disclose the situati or from the negative side, to av an improper impression. Assumi a $10,000 par value subscription 110,[3], the following entries are th typically suggested in accounti textbooks:[4]

Stock Subscriptions Receivable . .	11,000.00	
Capital Stock Subscribed .		10,000.
Paid-In Surplus . . .		1,000.

Then upon payment of the full purch price:

Capital Stock Subscribed . .	10,000.00	
Capital Stock		10,000.

If a balance sheet is drawn off any time prior to full payment of t subscription price, the amount ca ried in Paid-In Surplus quite nat rally leads the reader to assume th

[1] Ill. Rev. Stat. c. 32, § 157.18.

[2] " In the event of a sale of any shares by rea of any forfeiture, the excess of proceeds reali over the amount due and unpaid on su shares shall be paid to the delinquent subsc er. . . " *Id.* § 157.16.

[3] "Shares having a par value may be issued such consideration, not less than the par va thereof. . . " *Id.* § 157.17.

[4] Finney & Miller, Principles of Accounting Introductory 256 (5th ed. 1957); Karrenbr & Simons, Intermediate Accounting 591 (2 ed. 1953); Moyer & Mautz, Functional Accou ing (Intermediate) 257 (2nd ed. 1951).

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legal consideration for this amount was in fact received by the corporation. This would only be true if more than the premium had been paid in and if it is assumed that the first amount paid in is the premium rather than the par value. The latter assumption would be extremely hard to defend and is not a good solution to the problem. There seems to be no valid reason for claiming Paid-In Surplus upon an unpaid subscription except that the corporation has a reasonable expectation of receiving the legal consideration sometime in the future. But the same could be said of the par value of the stock and apparently no one suggests making an entry in the Capital Stock account for the par value of the stock until the legal consideration has been received in full.

Allowing Paid-In Surplus to be established when a subscription is received may put the corporation in a very tenuous position. If stock dividends are declared out of such surplus before payment of the subscription price, in effect, fully paid for shares are created without there ever having been paid into the corportion anything to support such shares. Their validity could be seriously questioned. Crediting the premium on stock subscriptions immediately to the Paid-In Surplus account also has the disadvantage of working against "full disclosure." If a balance sheet is draw up, the statement may present the anomalous situation of Subscriptions Receivable greater in amount that Capital Stock Subscribed. Nor could the statement reader ascertain what the subscription price was or what percentage of the price had been paid unless such facts were independently disclosed. All of these objections would be overcome by putting the full subscription price in the Capital Stock Subscribed account with a parenthetical expression, for balance sheet purposes, disclosing the par value of the subscribed stock. Paid-In Surplus would then be credited only when the subscription is fully paid and the stock certificates are issued. This procedure would not hide the total subscription price nor lead the reader to the false impression that the corporation had received legal consideration for all of its Paid-In Surplus.

When a subscriber defaults under the present method of accounting for stock subscriptions, the premium amount that was credited to the Paid-In Surplus account upon receipt of the subscription is not removed. Continuing the example given above, if a default occurs after, say, 40% of the subscription price has been received, the following entries would be made:

Capital stock Subscribed	10,000.00	
Stock Subscriptions Receivable		6,600.00
Contingent Refund — John Doe		3,400.00

This method permits the Contingent Refund account to be stated at an amount determined by the relationship between the par value of the stock subscribed and the amount still due from the subscriber. The amount so determined has very little relation to the actual contingent liability which is the amount paid in by the subscriber.[5] The resulting understatement in the Contingent Refund account is cured only when the stock is subsequently sold. If the selling price is lower than the original subscription price, the following entry would be made:

Cash	10,500.00	
Capital Stock		10,000.00
Contingent Refund—John Doe		500.00

[5] See note 3 *supra*.

If greater:

Cash	11,500.00	
Capital Stock		10,500.00
Paid-In Surplus		500.00
Contingent Refund—John Doe		1,000.00

The end result, after either of the above entries has been made, is correct, but the intervening error is neither desirable nor necessary.

Where the premium upon subscription is credited to the Capital Stock Subscribed account, the following entries could be made under the same default situation as above:

Captial Stock Subscribed . .	11,000.00	
Stock Subscriptions Receivable . . .		6,600.00
Contingent Refund—John Doe		4,400.00

The Contingent Refund account would be stated initially at the amount paid in by the defaulting subscriber which would be the maximum amount due to him in any event.

Upon a subsequent sale of the stock under default at a lower price, the following entry could be made:

Cash	10,500.00	
Contingent Refund—John Doe .	500.00	
Capital Stock		10,000.00
Paid-In Surplus . . .		1,000.00

Upon sale at a greater price:

Cash	11,500.00	
Capital Stock		10,000.00
Paid-In Surplus . . .		1,500.00

The end result would be the same as that reached by the other method given above, but the intervening error has been eliminated.

The practice of creating Paid-In Surplus upon receipt of a stock subscription, although based upon a reasonable expectation of receiving legal consideration for the shares subscribed, is misleading to the balance sheet reader since he is led to believe that the legal consideration has already been received. The directors of the corporation might also be misled in the same manner and declare a stock dividend out of the Paid-In Surplus so created. In form this would create fully paid for shares without the necessary consideration to support them. Then, too, the goal of "full disclosure" is not properly served. The creation of Paid-In Surplus when the subscription is received hides the total subscription price and makes it impossible to determine the percentage of the subscription price uncollected unless that information is independently given. All of these objections may be easily overcome by putting the full subscription price into the Capital Stock Subscribed account with a parenthetical expression of the par value for balance sheet purposes. This procedure would also simplify accounting for defaults by subscribers and would allow the Contingent Refund account, in connection with the default, to be stated at the proper amount.

DEBT FINANCING

By Elmer B. Hosking

For our discussion of corporate debt financing, I have approached it through four basic vehicles: Mortgage Loan, Purchase Lease (which appears on the balance sheet as a footnote item), Direct and Public Financing. The first two involve real estate. Each of them revolves around a proper relationship to the worth of a company and its credit. Therefore, let's turn our attention first to what we generally look for in this respect.

A credit check up from our view point includes an analysis of the general reputation of the firm, the type of business done, the length of time in business, its products and whether there is a continuing demand for those products. What is its industry position, its status with customers, suppliers and bankers, and is the financial condition in proper ratio to the proposed financing? What type of management does the business have? What is its ability and are there good "backup" men? The ability and permanency of management is just as important as the balance sheet. A good history of management with continuity may often overcome balance sheet deficiencies, but a good balance sheet will not and should not overcome poor management.

We analyze the earnings history of the company with considerable care. Essentially, this is a comparison of adjusted profits and the interest, principal or rent charges which the borrower proposes to undertake. The margin of coverage is considered highly significant along with the stability of performance and the current trend in earnings as a guide to the feasibility of the proposed investment. A satisfactory history of earnings generally indicates stability and safety. A satisfactory history of earnings, however, may not offset balance sheet deficiencies. Because we have had tremendous prosperity for some time past is no indication that this will continue forever.

There are certain guideposts or rules of thumb which may be applied as standards in evaluating a credit risk. These are somewhat arbitrary, therefore, require that they be used with judgment and with sufficient flexibility to take into account the fact that there may be a considerable difference in individual businesses.

Earnings

1) A "Good" coverage would be in excess of two times— nearer 2½ times.
2) Less than 2 times—about 1½ would be considered "thin." Very borderline.
3) Other things being equal, a "rental" coverage should be somewhat stronger —since this is calculated before taxes.
   An exception would be a retail operation, particularly a chain store.
4) Current earnings should show a "good" coverage. A current operating loss is very bad.

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5) A widely fluctuating coverage is not desirable. Stability is a desirable characteristic and may compensate for lack of wide margin.
6) The direction of sales and earnings is important. A current downward trend is a poor sign. In a growth business, coverage will not be good in early years.
7) The reaction of the company to economic conditions in the 1930s, in 1937-38, again in 1949 is quite significant. If losses were sustained it may mean a vulnerability to a reaction in business conditions.
8) The policy of the company regarding dividends should be reasonably conservative. Should not pay out more than 70%, less if the business is growing and expanding and there is need for additional capital.

Balance Sheet

In most instances:

1) Total debt should not exceed 50% of Net Worth. In some real estate cases 75%.
2) Long Term Debt should not exceed Net Working Capital.
3) Fixed assets should not exceed 75% of Net Worth and should not be over 50% in a retailer or wholesaler.
4) Cash and receivables combined should exceed total current liabilities except in a retail business. In the latter case, a deficit is to be expected.
5) Cash generally should equal or exceed income tax liabilities.

Now for the real estate side of the picture. It used to be that individual buildings were erected along the institutional line to last 50 years. But today the emphasis is on flexibility and fluidity. The preferred plant is a new, modern, general purpose plant. The desired size in square foot area is dependent upon the economic area where it is located. A modern, one-story building, having general purpose use, with a square foot area between 25,000 and 50,000 feet, is considered to be the most desirable. This is but a generalization, as plants of larger size are in demand in our larger metropolitan areas, and if the credit rating of the company is favorable it can overcome many plant deficiencies, including the size of the plant.

If a plant exceeds 100,000 square feet, particularly in a small community, credit factors are a strong determinant as to whether we will consider the transaction.

And now let's turn to the first of the four debt vehicles previously mentioned—the mortgage. This is a time-honored and popular method. However, the financing is limited by the value of the real estate, for the ratio of the loan to appraisal is generally not over two-thirds. The term of the loan is not fixed. It will likely range from 10 to 20 years and average out at 15 years. Interest rates are dependent upon market conditions at the time the loan is made.

Next, we come to the purchase-lease or sale-leaseback. Relatively new, it has come into prominence since the close of World War II. Still limited by the value of the real estate, it nevertheless permits higher borrowings than a mortgage inasmuch as the sale will probably be at book value or at a fair market value of the land and buildings. Industry finds it attractive for many reasons, not the least of which is the fact it frees up money for operating capital.

Rental rates are dependent on the credit of the occupant and the attractiveness of the real estate. The rates are done on two bases. One is on a level payment basis, which is a fixed amount—the same rental each year of the lease—and the other, the so-called high-low pattern, which calls for a higher rent for the early years of the lease and a lower rental during the latter part of the term. There are

many types of high-low patterns, but one in common use is the higher rental for a 15-year period and a lower rental for the last ten years of a 25-year primary lease.

The amortization of the investment in the early years on a constant level basis for 25 years amounts to only about 25% during the first ten years. This depreciation and write-down is sometimes considered inadequate, particularly if the plant is of a specialized nature. The high-low basis enables a faster write-down during the early term of the lease and, this fact plus the lower rental during the latter part, gives the tenant an attractive average rental during the entire term. The high-low pattern is preferred by some companies. It gets a lower average rent, for one thing. For another, it obligates itself to pay the higher rent during the period it can foresee high earnings. Thus, it provides a measure of security through the lower rental in the years which might not be so productive.

The yield rate to the lender or buyer on a purchase-lease transaction is generally higher that if it had made a mortgage on the same property, generally by as much as ½ to ¾ of a point. This is logical because of the higher percentage of investment on the part of the investor.

It is essential that the lease be firm with no escape or cancellation clauses in it. Situations of possible prepaid rent by the tenant should be avoided. The important thing to remember is that the lease is a paramount instrument which must be satisfactory to the lender.

Now, we get into the frequent question of re-purchase options which are demanded by many of the firms today. We look with a dim view on these—in fact we do not grant them. In the first place a re-purchase option can be considered 100% mortgage financing. In the second place, it is quite obvious that attractive real estate would always be repurchased, but unattractive real estate would not. We have, under certain conditions, granted what we term a rejectable re-purchase option at a predetermined price. This gives us the option of rejecting the re-purchase offer if we so desire. If we do reject it, we usually grant the tenant the right to cancel his lease.

In the so-called purchase-lease transaction, a stronger degree of credit support is required than in the ordinary mortgage transaction. Also, we do not feel it is sound business to invest money in a plant which is equivalent to the net worth of the company itself. Further, we do not like to engage in a purchase-lease transaction with a company of relatively new vintage. We feel, generally, that a company should have been tested under adverse conditions before we undertake the risk of making such an investment which will be amortized over a long period of years. Generally speaking, it is our opinion that a company should have a net worth of about $1,000,000 before it qualifies for a purchase-lease transaction. I am not talking of a mortgage, nor am I saying we won't make a purchase-lease where the net worth is less than a million. We have—many, many of them. But at the million dollar figure and above, there should be sufficient strength in the balance sheet to take care of the lean years, which always seem to creep into this thing.

This kind of financing is a tailored operation to an extent not found in the financing of other types of property. For that reason it is sometimes difficult to predict in advance whether the vehicle to be used should be a

mortgage loan or a purchase-lease. The location, the adaptability of the improvements and the particular position of the plant user may often decide this. Then, too, although any deal which stacks up for purchase-lease also qualifies for a mortgage loan in a lesser amount, the reverse is not always true. It does not follow that a deal which qualifies for a mortgage loan will also invoke interest on a lease-back basis. Many of them will—but not all.

The remaining vehicles of Direct and Public Financing have the advantage of not being limited by real estate value. Strictly credit loans, they are used for a variety of purposes including the financing of machinery and equipment. It is not my purpose to argue the merits or demerits of these methods. Each has its proper place.

You folks, more than I, are aware of the requirements and manner through which Public Issues are handled. Similarly, you are familiar with Direct Financing methods. I should like, however, to mention the participation feature of some of our direct note issues. Perhaps participation is not the right word. Let me illustrate what I mean by citing a recent case of ours. A company wanted to build and equip a new plant. Our Mortgage Department made a 20-year mortgage loan on the plant. Our Commercial and Industrial Loan Department made a 15-year note loan for the purchase of the equipment. The interest rate was the same in each transaction.

The sources of money tend to expand as the net worth of the company increases. Direct term loans and mortgage loans are the chief vehicles for less than a million dollar company. At about the million net worth mark purchase-lease generally becomes available. Generally public issues enter the picture at higher net worth figures. Of course there is equity financing available, but it is costly and has very little value to small owners who have struggled for years and don't want to share the fruits of their labors with a lot of outside owners.

Debt financing plays an important part in our present economy. There was a time when borrowing was considered unsound. However, this feeling has changed and it is now considered a proper tool. Proper use of debt in most instances results in a higher return to the common stockholder on his investment. To illustrate this, recently I analyzed a statement of an actual company. Its common stock earning rate had the common stockholders supplied all the capital would have been about 7½%. Actually, through the use of borrowed capital the earning rate to the common stockholders was nearly double or about 15%. Certainly if I can borrow money from another person and end up doubling my return on the money I put in, I am going to do it if I can find someone to lend me the money. So the question is not so much whether to go into debt, but rather to what extent.

I belong to the school of thought which believes in sensible corporate debt financing. Indeed, I think it a necessity if our gross national product is to expand, as it surely will.